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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

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2006 MAR 24 A 10:11

AZ CORP COMMISSION
DOCUMENT CONTROL

IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON
FOR UTILITY SERVICE BY ITS PARADISE
VALLEY WATER DISTRICT

DOCKET NO. W-01303A-05-0405

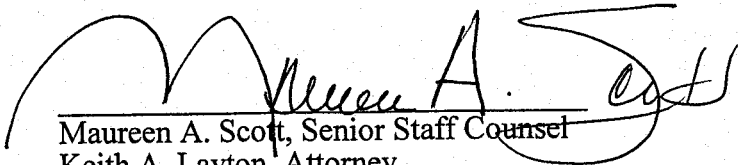
IN THE MATTER OF THE APPLICATION OF
OF ARIZONA-AMERICAN WATER
COMPANY, INC., AN ARIZONA
CORPORATION,
FOR APPROVAL OF AN AGREEMENT
WITH THE PARADISE VALLEY COUNTRY
CLUB

DOCKET NO. W-01303A-05-0910

**NOTICE OF FILING
TESTIMONY SUMMARY**

The Staff of the Arizona Corporation Commission ("Arizona Commission") hereby provides
Notice of Filing the Testimony summaries of Staff Witnesses Steve Olea, James J. Dorf, Darron W.
Carlson and Dennis Rogers.

RESPECTFULLY SUBMITTED this 24th day of March, 2006.


Maureen A. Scott, Senior Staff Counsel
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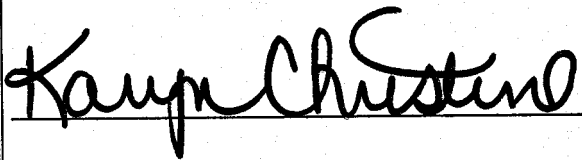
1 Original and fifteen (15) copies
2 of the foregoing were filed this
24th day of March, 2006 with:

3 Docket Control
4 Arizona Corporation Commission
5 1200 West Washington Street
Phoenix, Arizona 85007

6 Copies of the foregoing mailed this
24th day of March, 2006 to:

7 Craig A. Marks
8 Tom Broderick
9 Arizona-American Water Company
10 101 Corporate Center
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12 RUCO
1110 West Washington Street
Suite 220
13 Phoenix, Arizona 85007

14 
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**SUMMARY OF DIRECT TESTIMONY
OF JOHN A. CHELUS
ARIZONA-AMERICAN WATER COMPANY, INC.
PARADISE VALLEY DISTRICT
DOCKET NO. W-01303A-05-0405**

The testimony summary of staff witness Steve Olea addresses the following issues:

1. Mr. Steven Olea adopts Mr. Chelus' Direct Testimony and schedules. Mr. Chelus is no longer employed by the Utilities Division of the Arizona Corporation Commission.

Engineering's Findings:

2. The Paradise Valley Water District has a non-account water loss of 9.89 percent. This level is acceptable in this rate proceeding. (See Section C, Page 6 of Schedule JAC-1)
3. The most recent lab analysis for the Paradise Valley Water District indicates that six of the seven wells have Arsenic levels at or above 10 ppb. The Company is currently constructing arsenic removal equipment to achieve the new arsenic level of 10 parts per billion. (See Section E, Page 7 of Schedule JAC-1)
4. The Paradise Valley Water District is located within the Phoenix Active Management Area ("AMA") and is in compliance with the AMA's reporting and conservation requirements.
5. The Paradise Valley Water District has no outstanding Arizona Corporation Commission compliance issues.
6. The Paradise Valley Water District has a Curtailment Tariff on File with the Utilities Division.
7. Based on data submitted by the Maricopa County Environmental Services Department (MCESD), MCESD has determined that the Paradise Valley Water District is currently delivering water that meets the water quality standards required by Arizona Administrative Code, Title 18, Chapter 4.

Engineering and Plant Issues:

1. It is recommended that the Paradise Valley Water District continue to use depreciation rates as delineated in Exhibit 4 of Schedule JAC-1.
2. The findings of the field audit support the use, without adjustment, of the total post test year plant of \$3,018,867 as delineated in the table in Section J.3, Page 7. However, this "used and useful" determination does not imply a specific treatment for rate base or rate

making purposes. The direct testimony of Mr. Darron Carlson will discuss the post test year rate base and rate making treatment in this case.

3. Staff recommends the use of the Company's Cost of Service Study in this proceeding.

Fire Flow and Public Safety Surcharge Issues:

1. Mr. Olea is also responsible for any policy questions pertaining to Paradise Valley's Fire Flow Proposal.

SUMMARY OF TESTIMONY
ARIZONA-AMERICAN WATER COMPANY, INC
PARADISE VALLEY WATER DISTRICT
DOCKET NO. W-01303A-05-0405
STAFF WITNESS - JAMES J. DORF

The testimony summary of Staff witness James J. Dorf addresses the following issues:

Rate Base

1. Plant Held for Future Use – Staff has reconsidered its position based on information provided by Arizona-American Water Company, Inc. (“Company”) and will not recommend an adjustment to decrease test year Plant In-Service by \$138,682 for plant held for future use. The plant is used and useful.
2. Plant for Public Fire Safety – The Company agrees with Staff’s recommendation to increase Plant In-Service by \$3,018,867 to provide rate base treatment for the Company’s plant expenditures related to its fire safety program that was treated as Construction in Work in Process by the Company. Staff does not agree with the Company’s proposed additional increase to the fire safety plant of \$105,164 (revised upward to \$154,532 in rejoinder) for the Jackrabbit/Invergordon and McDonald mains project or the \$420,755 for Nauni Valley Drive. Staff did not receive supporting documentation for the \$105,164 until the Company filed rebuttal testimony. The Company further revised its amount in rejoinder to include depreciation adjustments and AFUDC through July, 2006. Staff would need additional time to evaluate these changes.
3. Accumulated Depreciation – The Company agrees with Staff’s recommended adjustment to increase the Company’s test year Accumulated Depreciation by \$107,315 for errors in applying the half-year convention depreciation methodology.
4. Working Capital - Deferred Maintenance – Staff has reconsidered its recommended adjustment and now agrees with the Company to include the deferred tank painting costs in rate base.
5. Working Capital – Cash Working Capital Allowance – Staff continues to recommend its adjustment to eliminate the Company’s revised calculation of a positive Cash Working Capital Allowance of \$94,745. Although the Company has accepted Staff’s lag days for property taxes, it has failed to meet the burden of proof demonstrating that it should have a positive cash working capital allowance. Additionally, RUCO is supporting a negative allowance.

Gain on Sale of Land

Staff recommends a shorter amortization period for a surcredit proposed by the Company related to the sharing of a gain of \$481,680.84 on the sale of land. The Company has indicated it accepts Staff’s recommendation for the shorter time period.

SUMMARY OF TESTIMONY
ARIZONA-AMERICAN WATER COMPANY, INC.
PARADISE VALLEY WATER DISTRICT
DOCKET NO. W-01303A-05-0405
STAFF WITNESS - DARRON W. CARLSON

The testimony summary of Staff witness Darron W. Carlson addresses the following issues:

Revenue Requirement

1. Mr. Carlson adopts Mr. Alexander Ibhade Igwe's direct testimony and schedules on behalf of Staff as his own. Mr. Igwe is no longer employed by the Utilities Division of the Arizona Corporation Commission ("Commission").
2. Staff recommends a \$199,020 or a 3.92 percent increase in revenue that allows Arizona-American Water Company, Inc. - Paradise Valley Water District ("Company") annual revenues of \$5,269,700 or a 7.24 percent rate of return on an original cost rate base ("OCRB") of \$14,165,666.
3. In recognition of the Company's efforts to substantiate its allocated corporate miscellaneous account, Staff is ready to alter its recommendation regarding this account in its direct and surrebuttal testimonies. Staff had recommended disallowance of the entire account. Staff now recommends that the account be recognized, subject to the adjustments recommended by RUCO and the adjustments offered by Company witness, Mr. Joel Reiker in the amount of \$2,153 in his supplemental response to Staff data request 7.1. This recommendation is not reflected in Staff's other summary figures.

Arsenic Cost Recovery Mechanism

4. Staff recommends approval of an arsenic cost recovery mechanism ("ACRM") as described by Staff in its direct testimony.

Rate Design

5. Staff generally concurs with the Company's rate design. Staff made adjustments to certain commodity charges to reflect Staff's lower recommended revenue requirement. Staff's recommended rates would increase the bill for a typical residential customer using the median of 11,500 gallons per month from \$16.81 to \$17.66 for an increase of \$0.85 or 5.06 percent.
6. Staff concurs with the Company in recommending a new "high-block" usage surcharge. Staff recommends approval of its more definitive description of the surcharge at \$2.15 per 1,000 gallons of usage in the top tier of each meter size and customer class.
7. Staff further recommends that all the funds collected from the "high-block" usage surcharge be treated as contributions-in-aid-of-construction ("CIAC") rather than revenue.
8. Staff further recommends that the CIAC funds collected from the "high-block" usage surcharge be used to offset the Company's public fire safety ("PFS") investments and reduce by a corresponding amount any allowance for funds used during construction ("AFUDC") accruals.
9. In its rebuttal testimony, the Company requested a second tier be added to its commodity charge, at no change in rate, for the Paradise Valley Country Club ("PVCC"). This would make PVCC subject to the "high-block" usage surcharge. Staff concurs.

(Continued on next page)

Public Fire Safety Surcharge

10. The Company requested a PFS surcharge in five phases in its direct testimony and revised its request to two phases in its rebuttal testimony. Staff recommended denial of the PFS surcharge in its direct and surrebuttal testimonies and continues to support the denial recommendation. However, Staff has developed an alternative recommendation for consideration by the Commission, should it choose to adopt some form of a PFS surcharge mechanism. Staff has recently filed this alternative recommendation with Docket Control.

Allowance for Funds Used During Construction

11. Staff also filed with Docket Control, a recommendation to alter the methodology of calculating AFUDC that was previously authorized for PFS investments in Decision No. 68303. Staff recommends that the Company be required to fully account for CIAC funding towards PFS investments prior to any calculation of AFUDC.

**ARIZONA-AMERICAN WATER COMPANY
PARADISE VALLEY WATER DISTRICT**

Docket No. W-01303A-05-0405

Staff Witness – Dennis Rogers

The pre-filed testimony of Staff witness Dennis Rogers addresses the following issues:

Capital Structure – Staff recommends that the Commission adopt a capital structure for Paradise Valley (“Applicant”) for this proceeding consisting of 63.3 percent debt and 36.7 percent equity.

Cost of Debt – Staff recommends that the Commission adopt a 5.42 percent cost of long-term debt.

Cost of Equity – Staff recommends that the Commission adopt a 10.4 percent return on equity (“ROE”) for Paradise Valley. Staff’s estimated ROE for the Applicant is based on Staff’s direct testimony cost of equity estimates for the sample companies ranging from 9.6 percent for the discounted cash flow method (“DCF”) to 10.0 percent for the capital asset pricing model (“CAPM”). Staff’s ROE recommendation includes a 0.6 percent upward adjustment attributable to the Applicant’s greater leverage than the sample companies.¹ Staff advises the Applicant not to expect Staff to recommend similar upward ROE adjustments due to financial risk in subsequent rate cases. Instead, the Applicant is advised to maintain greater equity in its capital structure.

Overall Rate of Return – Staff recommends that the Commission adopt an overall rate of return (“ROR”) of 7.2 percent.

Staff recommends requiring Paradise Valley to attain, and thereafter maintain, a capital structure (equity, long-term debt and short-term debt) with equity representing 40 to 60 percent of total capital prior to its next rate filing.

Dr. Kolbe’s Testimony - The Commission should reject the Company proposed 12.0 percent ROE because the empirical capital asset pricing model (“ECAPM”) used to derive it is inappropriately based on a market value capital structure instead of book value capital structure.

The present value concept is fundamental to modern financial theory for pricing all capital investments. Dr. Kolbe’s rejection of the present value concept for pricing stocks

¹ Staff’s surrebuttal testimony presents updated cost of equity estimates that are not significantly different from its direct testimony: DCF, 9.6 percent; CAPM, 9.4 percent; and a financial risk adjustment of 70 basis for an overall cost of equity estimate of 10.2 percent (Surrebuttal Schedule DRR-2). The updated overall rate of return is 7.1 percent (Surrebuttal Schedule DRR-1).

contradicts his use of the discounted cash flow method as one of the determinants in his cost of equity estimate.

Dr. Kolbe's use of market-value capital structures to determine the cost of equity is not widely recognized for utility rate-making. Further, Staff is not aware of any instance where the Arizona Corporation Commission has adopted this method and it is inappropriately dependent upon embedded debt cost.

Dr. Kolbe correctly recognized that Staff's financial risk adjustment is based on book values instead of market values as contemplated by the Hamada procedure. Staff prefers to use the book values because they are readily available, do not require making questionable assumptions regarding the market value of debt and their use is consistent with Staff's use of a book value capital structure. Staff recalculated the financial risk adjustment using Dr. Kolbe's market values. The financial risk adjustment calculated using market values is 20 basis points, 40 basis points less than Staff's recommended upward adjustment of 60 basis points.